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In the Supreme Court of the United States

OCTOBER TERM, 1997

BOWATER INCORPORATED AND SUBSIDIARIES,
PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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QUESTION PRESENTED

Whether, under the terms of the regulation that applied during the tax years involved in this case (26 C.F.R. 1.861-8 (1980)), interest income was to be netted against interest expense before allocating interest costs proportionally against the income of a domestic international sales corporation.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-12a) is reported at 108 F.3d 12. The opinion of the Tax Court (Pet. App. 17a-28a) is reported at 101 T.C. 207.

JURISDICTION

The judgment of the court of appeals (Pet. App. 13a-14a) was entered on March 3, 1997. A petition for rehearing was denied on June 9, 1997 (Pet. App. 15a-16a). On August 26, 1997, Justice Ginsburg extended the time within which to file a petition for a writ of certiorari to and including October 7, 1997 (Pet. App. 40a). The petition for a writ of certiorari was filed on October 3, 1997. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. During the years involved in this case, Congress provided special tax benefits to "domestic international sales corporations" (DISCs) in an effort to stimulate the export of goods manufactured in the United States and to encourage the export of these goods through domestic rather than foreign affiliates. 26 U.S.C. 991-997. The key feature of this legislative scheme was that these corporations were not directly subject to federal income taxes. 26 U.S.C 991; see 26 U.S.C. 992(a). The income received by these entities was instead allocated and taxed to their shareholders. A portion of the income was taxed as a constructive dividend when the income was earned. The remainder was taxed when it was distributed to the shareholders of the DISC, when the shareholders disposed of their DISC stock or when the DISC lost its exempt status. 26 U.S.C. 995(b), (c).[1]

This case concerns one of the special intercompany pricing rules for DISC entities contained in Section 994 of the Internal Revenue Code, 26 U.S.C. 994. These intercompany pricing rules governed the allocation of the profit from export transactions between

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[1] In 1984, the DISC provisions were supplanted for most entitites by the foreign sales corporation (FSC) rules (26 U.S.C. 921-927) that were enacted as part of the Deficit Reduction Act of 1984, Pub. L. No. 98-369, §§ 801-805, 98 Stat. 985-1003. The FSC rules were enacted in response to complaints from our international trading partners that the DISC system represented an illegal export subsidy in violation of the General Agreement on Tariffs and Trade. See S. Rep. No. 169, 98th Cong., 2d Sess. 634-635 (1984). When the FSC rules were enacted, Congress exempted from tax DISC income that had been accumulated through December 31, 1984. § 805(b)(2)(A), 98 Stat. 1001.

the domestic producer and its related DISC. The rules permitted a greater allocation of profits to the DISC than would ordinarily result from arm's length pricing. Because a portion of a DISC's income was deferred from tax under the statute, the effect of these favorable pricing rules was to increase the amount of taxes deferred and, therefore, the resulting tax benefit.

This case involves the "50/50 combined taxable income" pricing rule in Section 994(a)(2) of the Code (Pet. App. 4a). Under this pricing rule, the deemed transfer price from the domestic producer to the DISC for the sale of export property was the price that would allow the DISC to derive taxable income from the sale equal to (i) 50 percent of the combined taxable income of the DISC and its related supplier attributable to the sale plus (ii) 10 percent of the export promotion expenses attributable to the sale. 26 U.S.C. 994(a)(2). Treasury regulations issued under the statute to implement this pricing rule provided that "the combined taxable income of a DISC and its related supplier from a sale of export property is the excess of the gross receipts * * * of the DISC from such sale over the total costs of the DISC and related supplier which relate to such gross receipts" (26 C.F.R. 1.994-1(c)(6)). The regulations further provided that, in determining the total costs of the DISC and its related supplier relating to the sale of export property, the costs (other than the cost of goods sold) related to such gross receipts were to be "determined in a manner consistent with the rules set forth in [26 C.F.R.] § 1.861-8" (26 C.F.R. 1.994-1(c)(6)(iii)).[2]

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[2] The intercompany pricing method involved in this case is also used to compute FSC income. See note 1, *supra*; 26

The "rules set forth in [26 C.F.R.] § 1.861-8"—which thus governed the allocation of items of expense and income in determining the income of a DISC—have been issued in three different versions. See pages 12-16, *infra*; note 2, *supra*. This case involves the proper application of the *second* of the three versions of these rules—the version that was in effect between 1976 and 1986—to the business operations of petitioner during the 1979 and 1980 tax years.

2. Petitioner is a domestic corporation that produces wood pulp and other related products (Pet. App. 3a). During 1979 and 1980, petitioner owned two subsidiaries—Bowater Southern Paper Corporation (Southern) and Bowater Carolina Corporation (Carolina). These subsidiaries, in turn, each owned a DISC for which they were the "related supplier" (*id.* at 3a-4a).

In 1979 and 1980, petitioner filed consolidated federal income tax returns with the members of its affiliated group, which included Southern and Carolina and their DISCs (Pet. App. 4a, 18a). See 26 U.S.C. 1504. In these returns, petitioner computed the combined taxable income of each DISC and its related supplier by first offsetting their gross interest income against their gross interest expense

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U.S.C. 925(a)(2). For taxable years beginning after December 31, 1986, however, and thus for most of the years in which a calculation of FSC income would occur, the allocation of interest expenses for both DISC and FSC purposes is determined under a different version of 26 C.F.R. 1.861-8. *Compare* 26 C.F.R. 1.994-1(c)(6)(iii) (1980) *with* 26 C.F.R. 1.925(a)-1T(c)(6)(iii)(D). See T.D. 8228, 1988-2 C.B. 136, 144; Pet. App. 12a.

and then allocating the resulting combined net interest expense against their other income producing activities, including their receipts from the sale of export property (Pet. App. 4a).

On audit, the Commissioner determined that petitioner's method of calculating combined taxable income was incorrect and, as a consequence, that petitioner had deficiencies in income tax of $320,400 for 1979 and $686,700 for 1980 (Pet. App. 4a-5a). In the Commissioner's view, the proper method for computing combined taxable income under the controlling regulation was to allocate the gross interest expense of these entities equally against all of their income producing activities (*ibid.*). It was not, as petitioner had done, to net gross interest expense against gross interest income first, and only then to allocate the net interest expense to the remaining income producing activities (*ibid.*).

3. The case was presented to the Tax Court on a set of stipulated facts (Pet. App. 18a). The Tax Court concluded that petitioner had correctly calculated the combined taxable income of its DISCs and related suppliers by first netting their gross interest income against their gross interest expense and then allocating the resulting net interest expense to the entities based upon their gross receipts from other business activities, such as sales of export products (*id.* at 21a-28a).

4. The court of appeals reversed (Pet. App. 1a-12a). The court held that the plain language of the applicable regulations required that gross interest expense, not net interest expense, be allocated against the gross income produced by the DISCs and

their related suppliers (*id.* at 5a). The court of appeals explained (*ibid.*):

> The Commissioner argues that Treasury regulation § 1.861-8(e)(2) is clear on its face, and requires a taxpayer to allocate interest expense ratably to *all* income producing activities, including activities that produce income in the form of interest. * * * [W]e agree with the Commissioner.
>
> The plain language of Treasury regulation § 1.861-8(e)(2) controls the outcome of this case. The Regulation provides that "interest expense is attributable to *all* activities and property regardless of any specific purposes for incurring an obligation on which interest is paid," 26 C.F.R. § 1.861-8(e)(2)(i) (emphasis added), and "the aggregate of deductions for interest shall be considered related to *all* income producing activities and properties of the taxpayer and, thus, allocable to *all* the gross income which the income producing activities and properties of the taxpayer generate," 26 C.F.R. § 1.861-8(e)(2)(ii) (emphasis added). Interest is plainly a form of income, and activities that produce interest are plainly income producing activities. Thus, the Regulation requires that the aggregate of deductions for interest be allocated ratably to interest income on the same basis as it is allocated to *all* other income producing activities. The plain language of the Regulation allows for no exception.

The court of appeals further stated that, "under the Regulation's concept that money is fungible, a cash surplus is simply available cash, and available cash from one income producing activity is interchange-

able with cash from any other income producing activity" (Pet. App. at 8a). The court noted that "the Regulation implicitly takes the approach that all income producing activities contribute to the cost of borrowing money simply by tying up funds, and that investment in interest bearing securities is no different from investment in other income producing activities, such as stocks, new plants and equipment, inventory, etc., in this respect" (*id.* at 9a).

In concluding that the plain text of the regulation requires gross interest expense to be allocated equally to "all" income producing activities (rather than be charged first against gross interest income), the court of appeals criticized the decision of the Fifth Circuit in *Dresser Industries, Inc.* v. *Commissioner*, 911 F.2d 1128 (1990). In *Dresser*, the court had relied on what it asserted was "economic reality" in concluding that an earlier and different version of the Treasury regulation had permitted interest expense to be allocated first against interest income. *Id.* at 1135. In the present case, the court noted that the text of the regulation had been revised and clarified to require the conclusion reached in this case (Pet. App. 7a-8a n.6). The court further observed, however, that the concept of "economic reality" contained in *Dresser* was misguided because "it does not comport with the Regulation's concept that money is fungible" (*id.* at 8a):

> *Dresser* posits that interest expense is more related to interest income than it is to income by any other name. Yet, under the Regulation's concept that money is fungible, a cash surplus is simply available cash, and available cash from one

income producing activity is interchangeable with cash from any other income producing activity.

The court of appeals also rejected petitioner's contention that a *third* and more recent version of this same regulation (26 C.F.R. 1.861-9T(a)), which applies to all tax years beginning after December 31, 1986, "substantially changed the rules for the apportionment of interest expense by providing that '[t]he term interest refers to the gross amount of interest expense incurred by a taxpayer in a given year'" (Pet. App. 12a). The court of appeals agreed with the Commissioner that this third and most recent version of the regulation "merely reiterates, or clarifies," the requirements already contained in the second version of the regulation—the version that was at issue in this case (*ibid.*).

ARGUMENT

The decision of the court of appeals is correct and does not conflict with any decision of this Court or any other court of appeals. Moreover, in an amendment effective since 1987, the applicable regulation was revised expressly to require the very result reached by the court of appeals under the earlier version of the regulation involved in this case. Further review is therefore not warranted.

1. The decision of the court of appeals is correct for the reasons explained at length in the court's decision. As in effect during the years involved in this case, Section 1.861-8 of the Treasury Regulations established rules for allocating "expenses, losses, and other deductions" for various purposes under the Internal Revenue Code. 26 C.F.R. 1.861-8(a)(1), (f) (1980). The plain text of that regulation specified that "interest expense is attributable to

all activities and property regardless of any specific purposes for incurring an obligation on which interest is paid" (26 C.F.R. 1.861-8(e)(2)(i) (1980) (emphasis added)) and that "the aggregate of deductions for interest shall be considered related to *all* income producing activities and properties of the taxpayer and, thus, *allocable to all the gross income* which the income producing activities and properties of the taxpayer generate, have generated, or could reasonably have been expected to generate." 26 C.F.R. 1.861-8(e)(2)(ii) (1980) (emphasis added).

As the court of appeals concluded, under the "plain language" of this regulation, interest expense must "be allocated ratably to interest income on the same basis as it is allocated to *all* other income producing activities" (Pet. App. 5a). The court of appeals thus correctly held that the allocation procedure advocated by petitioner—which would allocate interest expense first against interest income—is prohibited by the plain requirement of the regulation that interest expense be allocated ratably to "all" of the income producing activities of the taxpayer.

2. In an attempt to evade this "plain language" of the regulation, petitioner engages in a selective reading of its provisions. Subparagraph (e)(2)(i) of the regulation (entitled "In general") provides an overview for the more specific subparagraphs of 26 C.F.R. 1.861-8(e)(2) that establish the precise rules for allocating interest expense. The "general" overview provision states that the "allocation and apportionment for interest * * * is based on the approach that money is fungible and that interest expense is attributable to all activities and property regardless of any specific purpose for incurring the

obligation on which the interest is paid." 26 C.F.R. 1.861-8(e)(2)(i) (1980). The specific provision entitled "Allocation of interest" (26 C.F.R. 1.861-8(e)(2)(ii) (1980)) provided the concrete governing rule by specifying that "interest shall be considered related to all income producing activities" (*ibid.*).

In arguing that the court erred in this case, petitioner ignores the specific provisions of the regulation that establish the proper procedure for "[a]llocation of interest" (26 C.F.R. 1.861-8(e)(2)(ii) (1980)) and instead relies solely on the three words "money is fungible" contained in the "general" introductory subsection of the regulation (Pet. 8-12). It is obviously telling that petitioner fails to discuss—or even to acknowledge the existence of—the "plain language" of the specific, governing provisions of the regulation on which the court of appeals relied. Moreover, as the court of appeals explained in detail, it is the very fact that "money is fungible" that explains *why* the regulation requires interest costs "to be allocated accross the board to all income producing activities" (Pet. App. 6a, 7a):[3]

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[3] The requirement that gross interest expenses be allocated to "all" income producing activities is based on the fact that "money is fungible and that interest expense is attributable to all activities and property regardless of any specific purpose for incurring the obligation on which the interest is paid." 26 C.F.R. 1.861-8(e)(2)(i). As the court of appeals emphasized (Pet. App. 8a):

> under the Regulation's concept that money is fungible, a cash surplus is simply available cash, and available cash from one income producing activity is interchangeable with cash from another income producing activity.

Petitioner's contrary speculations about "business realities and common sense" (Pet. 11)—which the court of appeals politely

> The regulation says that *all* money is fungible, without exception for money that comes in as interest or goes out as interest, and uses this concept of fungibility to explain why interest expenses must be allocated to all income producing activities. See 26 C.F.R. § 1.861-8(e)(2)(i). Taxpayer's tortured application of the principle that money is fungible does not justify amending the Regulation to provide an exception for interest income.

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referred to as "debatable economic theory" (Pet. App. 10a)—do not support petitioner's efforts to nullify the "plain language" of the 1977 version of the regulation (*id.* at 5a). Moreover, as the court of appeals emphasized, if petitioner's two-tiered allocation theory were accepted, similarly situated taxpayers would be treated differently under the regulation (*id.* at 10a-11a):

> Suppose DISC #1 invested its temporary cash surplus in interest bearing securities while DISC #2 invested in dividend paying stock. Under taxpayer's approach, DISC #1 and its related supplier would allocate interest expenses to interest income prior to allocating the remaining "net interest expense" to the income earned from the sale of export property. Meanwhile, DISC #2 and its related supplier would allocate the interest expense, unreduced by interest income, to the income earned from the sale of export property as well as to the dividends earned from the stock investment. Taxpayer's approach of allocating interest expense would result in a higher [combined taxable income] in the first DISC and its related supplier than in the second, solely because of the nature of the investment of the surplus funds.

The court of appeals properly concluded that there is no basis for a "judicially created exception to the Regulation's clear mandate that interest expense be allocated to all income producing activities" (*id.* at 11a).

Indeed, as the Treasury explained in 1988, it is "[b]ecause money is considered to be fungible [that] interest expense is attributable to all activities and property regardless of any specific purpose for incurring an obligation on which interest is paid." T.D. 8228, 1988-2 C.B. 137.

3. a. Three different versions of this regulation have been in force at various times. Prior to 1976, the first version of the regulation did not expressly require interest expense to be allocated among "all" income producing activities. See Pet. App. 7a-8a n.6. Under that early version of the regulation, the Fifth Circuit held in *Dresser Industries, Inc.* v. *Commissioner*, 911 F.2d at 1135, that interest expense should first be netted against interest income and that only the resulting net interest expense should then be allocated to other income-producing activities.

b. In 1977, however, the regulation was amended to specify that interest expense was to be allocated among "all" income producing activities. 26 C.F.R. 1.861-8(e)(2)(i), (ii) (1980). In *Dresser*, which involved the *first* version of the regulation, the court noted that the regulation had been thus "substantially revised" in 1977. 911 F.2d at 1134 n.11. Because that case involved taxes due for years before the regulation was amended, however, the court concluded in *Dresser* that "[w]e need not and do not address the question whether interest netting is consistent with the [1977] version of the Treasury Regulations" (*ibid.*).

The present case, by contrast, involves the provisions of the regulation as amended in 1977. In following the "plain language" of the amended version of the regulation, the court of appeals noted in the

present case that "*Dresser* arose under an earlier version of the Regulations that was much less clear" (Pet. App. 7a n.6).[4] The court in *Dresser* emphasized that it "need not" and would not address the question whether interest netting is permitted under the 1977 version of the regulation that is involved in the present case.[5] The question that the court in *Dresser*

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[4] Petitioner asserts, without any supporting analysis, that there is "no meaningful difference" between the first two versions of the regulation (Pet. 8). In making that assertion, petitioner fails to acknowledge the existence and content of subparagraph (e)(2)(ii) of the regulation, which specifies that "interest shall be considered related to all income producing activities and properties of the taxpayer." 26 C.F.R. 1.861-8(e)(2)(ii). As the court of appeals emphasized, this language did not exist in the "earlier version of the regulations that was much less clear" that was involved in the *Dresser* case (Pet. App. 7a n.6). Petitioner simply ignores this obvious and highly pertinent distinction in the text of the two regulations.

The Fifth Circuit emphasized in *Dresser* that the 1977 version of 26 C.F.R. 1.861-8 was not "controlling" in that case. 911 F.2d at 1135. The court nonetheless suggested that the reference in the 1977 version of the regulation to the fungibility of money was consistent with its decision under the prior regulation. *Ibid.* In making that statement in dicta, however, the Fifth Circuit gave no consideration to the "plain text" of subparagraph (e)(2)(ii) of the 1977 regulation, which was controlling in this case (Pet. App. 5a).

[5] Similarly, neither the decision of the Fifth Circuit in *General Portland Cement Co.* v. *United States*, 628 F.2d 321, 343-344 (1980), cert. denied, 450 U.S. 983 (1981), nor the decision of the Tax Court in *Ideal Basic Industries, Inc.* v. *Commissioner*, 82 T.C. 352, 401-402 (1984), which petitioner cites (Pet. 10), is relevant to the proper interpetation of the regulation involved in this case. Each of those cases presented the question whether gross interest expense or net interest expense should be used in determining the taxable income from depletion property for purposes of the limitation on the per-

stated that it "need not" answer is precisely the question that the court addressed and answered in this case. The suggestion that petitioner now makes that the decision in *Dresser* "directly conflicts" (Pet. 8) with the decision in this case is thus plainly incorrect.

Indeed, the present case is the only appellate decision that has analyzed the governing language of the 1977 version of the regulation.[6] There is obviously no conflict among the courts of appeals as to the meaning of the "plain language" (Pet. App. 5a) of 26 C.F.R. 1.861-8(e)(2)(ii) (1980), for no other court of appeals has addressed and interpreted that provision. See note 4, *supra*.

c. Moreover, as the court of appeals noted (Pet. App. 12a), a *third* version of this same regulation was adopted in 1987. That 1987 version replaced the 1977 version involved in this case. For all tax years beginning after December 31, 1986, the new regulation issued in 1987—rather than the 1977 regulation involved in this case or the pre-1977 regulation that was involved in *Dresser*—is controlling. The 1987 version of the regulation contains language that

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centage depletion deduction in Section 613 of the Internal Revenue Code, 26 U.S.C. 613. Neither of those decisions involved the regulation at issue in this case, which requires interest to be allocated to "all" of the taxpayer's income producing activities. 26 C.F.R. 1.861-8(e)(2)(i), (ii) (1980).

[6] The opinions of the Tax Court that have adopted the Fifth Circuit's opinion in *Dresser* (*Coca-Cola Co.* v. *Commissioner*, 106 T.C. 1 (1996); *Bowater Inc.* v. *Commissioner*, 101 T.C. 207 (1993); *Computervision Int'l Corp.* v. *Commissioner*, 71 T.C.M. (CCH) 2450 (1996)) have not considered the governing text of the amended regulation contained in 26 C.F.R. 1.861-8(e)(2)(ii) (1980).

"clarifies" the 1977 version (Pet. App. 12a). The 1987 version specifies that (26 C.F.R. 1.861-9T(a) (emphasis added)):

> Any expense that is deductible under section 163 (including original issue discount) constitutes interest expense for purposes of this section * * * . *The term interest refers to the gross amount of interest expense incurred by a taxpayer in a given tax year.* The method of allocation and apportionment for interest set forth in this section is based on the approach that, in general, money is fungible and that interest expense is attributable to all activities and property regardless of any specific purpose for incurring an obligation on which interest is paid. * * * The fungibility approach recognizes that all activities and property require funds and that management has a great deal of flexibility as to the source and use of funds. * * * Consistent with the principles of fungibility, except as otherwise provided, *the aggregate of deductions for interest in all cases shall be considered related to all income producing activities and assets of the taxpayer and, thus, allocable to all the gross income which the assets of the taxpayer generate*, have generated, or could reasonably have been expected to generate.

In noting that this new version of the regulation "clarifies" the preexisting requirement that "gross" rather than "net" interest expense be allocated among "all" business activities, the court of appeals rejected petitioner's contention that the new version of the regulation "substantially changed the rules for the apportionment of interest expense" (Pet. App.

12a). In the court below, if not here, petitioner thus recognized that the 1987 regulation requires allocation of "gross" interest expense to "all" business activities.

4. The 1987 regulation has now been in effect for more than a decade. There is no recurring administrative importance to the issue petitioner seeks to raise in this case concerning the "second" version of the regulation that applied for tax years between 1977 and 1987. Nor is there any conflict among the courts of appeals as to the meaning of the regulation for that period *or* for the period subsequent to 1987. Further review of the decision in this case is therefore not warranted.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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